

## Internal Revenue Service

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Re:

### LEGEND

Settlor =  
Trust =

Subtrust 1 =

Subtrust 2 =

Subtrust 3 =

Subtrust 4 =

Subtrust 5 =

Subtrust 6 =

Subtrust 7 =

Subtrust 8 =

Subtrust 9 =

Subtrust 10 =

Subtrust 11 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

A =

B =

C =

D =

E =

F =

G =

H =

Year 1 =

Year 2 =

Corporation =

Company =

Holding Company =

New Trust =

State =

Co-trustee =

Local Court =

the Act =

Statute A =

Statute B =

Statute C =

Statute D =

Dear :

This is in response to the May 4, 2005 letter and other correspondence requesting rulings on the income, gift, and generation-skipping transfer (GST) tax consequences of the consolidation and proposed modification of certain trusts.

The facts submitted are as follows. Settlor created Trust, an irrevocable trust, on Date 1, before September 25, 1985, for the benefit of A, B, C, D, E, F, and G, her nephews and niece (“the Original Beneficiaries”), and their issue. Settlor died on Date 2.

Under Article Fourth of the Trust, the net income is to be divided into equal shares at least annually with one share payable to each such nephew and niece. In the event a niece or nephew dies prior to termination of the trust, payment is to be made to or for his or her living issue by right of representation.

Under Article Third, no distribution of principal is to be made until the termination of the Trust. Under Article Fifth, the Trust is to terminate on the death of the last survivor of the named nephews and niece and all of the children of H, plus a period of twenty-one years. On termination, the principal is to be distributed in equal shares, one share for each child then surviving of the Original Beneficiaries and one share for the issue then surviving of any then deceased child of the Original Beneficiaries. If, at any time before the termination date, all of the Original Beneficiaries are deceased and there are no living issue of a deceased Original Beneficiary, then on the death of the last survivor of the Original Beneficiaries and their issue, the principal is to be distributed to the persons then living who would be Settlor's heirs at law as though Settlor had died intestate.

Article Eighth (K) provides that no stock dividends shall be considered as income but the same shall be considered as an increment in the value of principal and added to principal. No appreciation in value of principal nor profit resulting from the sale or disposition of any principal shall be considered as income but likewise as an increment in the value of principal. In the case of sale or disposition of principal, the profit shall be added to the principal. All cash dividends, except liquidating dividends, shall be considered as income.

Article Eighth (Q) provides that as soon as the trustees may find an actual physical division and setting aside of portions of the property held in the Trust to be feasible and for the best interests of the several beneficiaries, the Trust is to be divided, making such division as nearly as possible in the exact proportions required.

Under Article Twentieth, the Trust is to be governed by the laws of State.

Since its inception, the Trust has been administered as separate trusts, currently Subtrusts 1-11, each for the benefit of a beneficiary and his or her issue, for certain administrative and tax reporting purposes. The trustees have found this to be costly and cumbersome. As permitted under Statute D, the separate subtrusts have been consolidated into a single trust ("New Trust") governed by the terms of the Trust, as amended by the judicial modification described below.

The Trust was initially funded with shares of Corporation, an operating business. In Year 1, Corporation became a wholly owned subsidiary of Company, and the Trust's shares of Corporation were exchanged for shares of Company. Corporation's operating business was sold in Year 2, and Company changed its name to Holding Company. On

Date 3, Holding Company undertook a plan of partial redemption. The principal now consists of the remaining Holding Company shares and investment assets such as stocks, bonds, and real estate.

Holding Company is an S Corporation for federal tax purposes. Each trust under the Trust elected to be an “electing small business trust” under section 1361(e)(1)(B).

Effective September 1, 2002, State enacted the Act, which includes Statute A and Statute B, governing the administration of trusts.

Under Statute A, (1) in allocating receipts and disbursements to or between principal and income, a fiduciary shall: (a) administer a trust in accordance with the terms of the trust, even if there is a different provision in the Act; (b) administer a trust in accordance with the Act if the terms of the trust do not contain a different provision or give the fiduciary a discretionary power of administration; (c) add a receipt or charge a disbursement to principal to the extent that the terms of the trust and the Act do not provide a rule for allocating the receipt to or between principal and income; (2) a fiduciary may administer a trust by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust, even if the exercise of the power produces a result different from a result required or permitted under the Act; (3) in exercising the power to adjust under Statute B, or a discretionary power of administration regarding a matter within the scope of the Act, whether granted by the terms of the trust or as provided in the Act, a fiduciary shall administer a trust impartially, based on what is fair and reasonable to all of the beneficiaries except to the extent that the terms of the trust clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with the Act is presumed to be fair and reasonable to all of the beneficiaries.

Under Statute B, (1) a fiduciary may adjust between principal and income to the extent the fiduciary considers necessary if the fiduciary invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may be distributed to a beneficiary by referring to the trust’s income, and the fiduciary determines, after applying the provisions of Statute A(1) and (2), that the fiduciary is unable to comply with Statute A(3); (2) in deciding whether and to what extent to exercise the power conferred by Statute B(1), a fiduciary shall consider all factors relevant to the trust and its beneficiaries.; (3) in exercising discretion under Statute B, a professional trustee may adopt a policy that applies to all trusts, or a policy that applies to individual trusts or classes of trusts, stating whether and under what conditions it will use the adjustment power and the method of making adjustments.

Statute C contains the State prudent investor rule.

On Date 4, pursuant to the co-trustee’s petition, Local Court issued an order modifying the Trust, as follows: (i) the limitations of Article Eighth (K) shall not apply in

determining the income of the trust; (ii) income shall be determined in accordance with the Act; and (ii) Article Third shall be amended to provide that the trustees will have the power to distribute principal to the extent necessary to allow the them to exercise their power to adjust under the Act. In exercising their power to adjust between principal and income, the trustees may consider: (a) the overall return on investments that have been or will be generated from the trust principal each year; (b) the level of distributions that have been historically provided to the beneficiaries; and (c) the impact inflation has on the value of the trust principal to future beneficiaries and the value of the distributions to current beneficiaries. Local Court's order is contingent on the receipt of a private letter ruling issued by the IRS concluding that the modifications will not affect the generation-skipping transfer tax exempt status of the trust.

It is represented that the Trust (including the separately administered Subtrusts 1-11) was irrevocable on September 25, 1985, and there were no additions made after September 25, 1985.

#### Rulings requested

You have requested the following rulings:

- (1) After the consolidation, New Trust will be considered to have been created and become irrevocable before September 25, 1985, and will be exempt from the generation-skipping transfer tax.
- (2) The judicial modification will not cause the Trust or New Trust to lose its status as exempt from generation-skipping transfer tax.
- (3) The consolidation will not constitute a transfer by any beneficiary that will be subject to the gift tax under section 2501.
- (4) The judicial modification will not result in a taxable gift under section 2501.
- (5) The consolidation will not result in the realization of income, gain or loss under section 61 or section 1001.
- (6) The judicial modification will not cause there to be a disposition for purposes of section 1001 and will not result in the recognition of gain or loss.
- (7) The consolidation will result in New Trust having assets with the same basis as held by the trusts immediately prior to the consolidation.
- (8) The holding periods for all of the assets of New Trust will include the trusts' holding period for such assets under section 1223.

- (9) New Trust, as modified by the judicial modification, will satisfy the requirements of section 1361(e)(1).

Rulings 1 - 4

Section 2501 imposes a tax on the transfer of property by gift by an individual.

Section 2511 provides that the tax imposed by section 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 2601 imposes a tax on every generation-skipping transfer ("GST") made after October 26, 1986. A GST is defined under section 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under section 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under section 1433(a) of the Tax Reform Act of 1986 (Act) and section 26.2601-1(a), the GST tax is generally applicable to GSTs made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i), the GST tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added). Under section 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under section 2038 or 2042, if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under section 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. Under the regulation, unless specifically provided otherwise, these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (unless specifically noted), the rules do not apply in determining, for example, whether the transaction results in a gift subject

to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of section 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust, including a trustee distribution, settlement, or construction that does not satisfy section 26.2601-1(b)(4)(i)(A), (B), or (C) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of section 1.643(b)-1.

Section 26.2601-1(b)(4)(i)(E), Example 6, considers a situation where the grantor, in 1980, establishes an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the merger. In addition, the merger does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in

the original trust. Therefore, the example concludes that the trust that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Section 26.2601-1(b)(4)(i)(E), Example 12, considers a situation where, in 1980, the Grantor, a resident of State X, establishes an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death, the remainder passes to A's issue per stirpes. In 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The example concludes that the administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes.

In the instant case, the Trust (and Subtrusts 1-11) was irrevocable on September 25, 1985, and there were no additions made after September 25, 1985. The terms of the Trust and New Trust are identical. The consolidation of the trusts does not shift any beneficial interest in the Trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interests prior to the consolidation. In addition, the consolidation does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the New Trust resulting from the consolidation will not be subject to the provisions of chapter 13. Section 26.2601-1(b)(4)(E), Example 6. Further, since the beneficial interests of the beneficiaries before and after the consolidation are identical, the merger and consolidate did not result in any beneficiary being treated as making a gift for federal gift tax purposes.

Further, the trustees propose to administer New Trust pursuant to State Statute B, a statute that is similar to the state statute described in section 26.2601-1(b)(4)(i)(D)(2) and section 26.2601-1(b)(4)(i)(E), Example 12. Therefore, administration of New Trust in accordance with State Statute B will not be considered to shift any beneficial interest in Trust or New Trust for GST tax purposes, nor will administration of New trust in accordance with State Statute B cause any beneficiary to be treated as making a gift. The modifications to the Trust instrument, as described above, are consistent with the



administrative powers the trustees would otherwise possess in administering New Trust under Statute B.

Accordingly, based on the facts submitted and representations made, we conclude that: (1) The consolidation and merger of Subtrusts 1-11 into New Trust will not cause New Trust to be subject to the provisions of Chapter 13; (2) The consolidation and merger of Subtrusts 1-11 into New Trust will not constitute a transfer by any beneficiary that will be subject to the gift tax under section 2511; (3) Administration of New Trust pursuant to

Statute B and the modification of the Trust instrument as described above, will not cause Trust or New trust to lose status as exempt from GST tax; and (4) Administration of New Trust pursuant to Statute B and the modification of the Trust instrument as described above, will not cause any beneficiary of New Trust to be treated as making a gift for federal gift tax purposes.

#### Rulings 5 - 7

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under section 61(a)(15), from an interest in a trust.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under section 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

Section 1015(b) provides that if property is acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized by the grantor on such transfer.

Section 1.643(b)-1 provides that a switch between methods of determining trust income authorized by state statutes will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interest in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution. The issue presented was whether a sale or exchange had taken place resulting in a realization of gain or loss under section 1001.

The Court concluded that section 1.1001-1 reasonably interprets section 1001(a) and stated that an exchange of property gives rise to a realization event under section 1001(a) if the properties exchanged are "materially different." Cottage Savings, 499 U.S. at 560-61. In defining what constitutes a "material difference" for purposes of section 1001(a), the Court stated that properties are "different" in the sense that is "material" so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

It is consistent with Cottage Savings to find that the interests of the beneficiaries of New Trust after the judicial modification will not differ materially from their interests in the Subtrusts prior to the consolidation. Each beneficiary will continue to hold the same beneficial interest as before the consolidation, and under the same terms. Accordingly, the consolidation of the Subtrusts into New Trust will not result in a material difference in kind or extent of the legal entitlements, and no gain or loss is recognized on the consolidation for purposes of section 1001(a). Because section 1001 does not apply to the consolidation of New Trust, under section 1015 the basis of the assets will be the same after the consolidation as the basis of those assets before consolidation.

It is also consistent with Cottage Savings to find that the interests of the beneficiaries after the judicial modification will not differ materially from their interests prior to the judicial modification. Because the Act grants the trustees the power to administer the New Trust in the same manner as proposed in the modifications, the modifications are not treated as an exchange of interests by the beneficiaries or New Trust. Except for the changes described above, all other provisions of New Trust will be identical to the Trust. Accordingly, the proposed judicial modification will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized for purposes of section 1001.

Consequently, the proposed consolidation will not result in the realization of income, gain or loss under section 61 or 1001 by the Trust, the separate trusts, New Trust or any beneficiary of the separate trusts or New Trust. The proposed judicial modification of the Trust and New Trust will not cause there to be a disposition for purposes of section 1001 and, therefore, no gain or loss is recognized on the consolidation. The New Trust

assets will have the same basis as held by the Subtrusts prior to the consolidation.

#### Ruling 8

Section 1223(2) provides that in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which the property was held by any other person, if under Chapter 1 of the Code such property has, for the purposes of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

Assuming the assets transferred from Subtrusts 1-11 to New Trust will have the same basis before and after the consolidation, we conclude that the holding periods for the assets held by New Trust will include the holding periods of those assets when held in Subtrusts 1-11, under section 1223.

#### Ruling 9

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in section 1361 (c)(2), or an organization described in section 1361(c)(6) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(v) provides that an ESBT (as defined in section 1361(e)) is a permitted S corporation shareholder. Section 1361(e)(1)(A) provides that for purposes of section 1361, and except as provided in section 1361(e)(1)(B), the term ESBT means any trust if (i) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2), (3), (4), or (5); (ii) no interest in the trust was acquired by purchase; and (iii) an election under section 1361(e) applies to the trust.

Section 1361(e)(1)(B) provides that the term "electing small business trust" shall not include (i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection (d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under this subtitle, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

Section 1361(e)(3) provides that such an election is to be made by the trustee and is to apply to the tax year of the trust for which made and all subsequent tax years unless

revoked with the consent of the Service.

Based solely on the information submitted and the representations made, we conclude that after the proposed judicial modifications are adopted, the modifications will not result in a change in the beneficiaries of the trusts or otherwise alter the qualification of New Trust as an electing small business trust (ESBT). Thus, New Trust will continue to satisfy the eligibility requirements of section 1361(e).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether Holding Company is eligible to be treated as an S corporation, or the validity of its election to do so.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

George L. Masnik  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures  
Copy for section 6110 purposes